

CADIZ INC  
Form 10-Q  
November 05, 2015

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United States

Securities and Exchange Commission

Washington, D. C. 20549

FORM 10-Q

(Mark One)

☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the quarterly period ended September 30, 2015

OR

☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the transition period from ..... to .....

Commission File Number 0-12114

Cadiz Inc.

(Exact name of registrant specified in its charter)

DELAWARE  
(State or other jurisdiction of  
incorporation or organization)

77-0313235  
(I.R.S. Employer  
Identification No.)

550 South Hope Street, Suite 2850  
Los Angeles, California  
(Address of principal executive offices)

90071  
(Zip Code)

Registrant's telephone number, including area code: (213) 271-1600

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer      Accelerated filer ☒      Non-accelerated filer      Smaller Reporting Company

Indicate by check mark whether the Registrant is a shell company (as defined in Exchange Act Rule 12b-2).  
Yes      No ☒

As of November 4, 2015, the Registrant had 17,870,855 shares of common stock, par value \$0.01 per share, outstanding.

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Cadiz Inc.

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## Consolidated Statements of Operations and Comprehensive Loss (Unaudited)

(\$ in thousands except per share data)	For the Three Months Ended September 30,	
	2015	2014
Revenues	\$227	\$305
Costs and expenses:		
Cost of sales	291	282
General and administrative	3,515	2,335
Depreciation	72	63
Total costs and expenses	3,878	2,680
Operating loss	(3,651 )	(2,375 )
Interest expense, net	(2,313 )	(2,190 )
Other income	-	-
Loss before income taxes	(5,964 )	(4,565 )
Income tax provision	1	1
Net loss and comprehensive loss applicable to common stock	\$(5,965 )	\$(4,566 )
Basic and diluted net loss per common share	\$(0.33 )	\$(0.28 )
Basic and diluted weighted average shares outstanding	17,822	16,186

See accompanying notes to the consolidated financial statements.

## Consolidated Statements of Operations and Comprehensive Loss (Unaudited)

(\$ in thousands except per share data)	For the Nine Months Ended September 30,	
	2015	2014
Revenues	\$283	\$320
Costs and expenses:		
Cost of sales	291	282
General and administrative	9,914	7,324
Depreciation	198	190
Total costs and expenses	10,403	7,796
Operating loss	(10,120 )	(7,476 )
Interest expense, net	(6,744 )	(6,296 )
Other income	70	-
Loss before income taxes	(16,794 )	(13,772 )
Income tax provision	3	3
Net loss and comprehensive loss applicable to common stock	\$(16,797 )	\$(13,775 )
Basic and diluted net loss per common share	\$(0.95 )	\$(0.85 )
Basic and diluted weighted average shares outstanding	17,752	16,175

See accompanying notes to the consolidated financial statements.

## Consolidated Balance Sheets (Unaudited)

(\$ in thousands except share data)	September 30, 2015	December 31, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 6,395	\$ 16,206
Accounts receivable	283	239
Prepaid expenses and other	493	346
Total current assets	7,171	16,791
Property, plant, equipment and water programs, net	44,546	43,640
Goodwill	3,813	3,813
Debt issuance costs	651	837
Other assets	3,345	3,131
Total assets	\$ 59,526	\$ 68,212
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 553	\$ 302
Accrued liabilities	1,786	1,580
Current portion of long-term debt	36,933	11
Total current liabilities	39,272	1,893
Long-term debt, net	73,186	104,384
Deferred revenue	750	750
Other long-term liabilities	923	923
Total liabilities	114,131	107,950
Stockholders' deficit:		
Common stock - \$.01 par value; 70,000,000 shares authorized; shares issued and outstanding – 17,861,658 at September 30, 2015 and 17,681,274 at December 31, 2014	179	177
Additional paid-in capital	321,532	319,604
Accumulated deficit	(376,316)	(359,519)
Total stockholders' deficit	(54,605)	(39,738)
Total liabilities and stockholders' deficit	\$ 59,526	\$ 68,212

See accompanying notes to the consolidated financial statements.



## Consolidated Statements of Cash Flows (Unaudited)

(\$ in thousands)	For the Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net loss	\$(16,797 )	(13,775 )
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation	198	190
Amortization of debt discount and issuance costs	679	637
Interest expense added to loan principal	6,065	5,659
Compensation charge for stock and share option awards	721	545
Changes in operating assets and liabilities:		
Increase in accounts receivable	(44 )	(239 )
Increase in prepaid expenses and other	(147 )	(201 )
Increase in other assets	(214 )	(214 )
Increase (decrease) in accounts payable	253	(249 )
Decrease in accrued liabilities	(147 )	(842 )
Net cash used for operating activities	(9,433 )	(8,489 )
Cash flows from investing activities:		
Additions to property, plant and equipment	(351 )	(25 )
Net cash used for investing activities	(351 )	(25 )
Cash flows from financing activities:		
Principal payments on long-term debt	(27 )	(8 )
Net cash used for financing activities	(27 )	(8 )
Net decrease in cash and cash equivalents	(9,811 )	(8,522 )
Cash and cash equivalents, beginning of period	16,206	11,887
Cash and cash equivalents, end of period	\$6,395	\$3,365

See accompanying notes to the consolidated financial statements.

## Consolidated Statement of Stockholders' Deficit (Unaudited)

(\$ in thousands except share data)

	Common Shares	Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Deficit
Balance as of December 31, 2014	17,681,274	\$177	\$319,604	\$ (359,519 )	\$ (39,738 )
Stock-based compensation expense	53,751	1	922	-	923
Issuance of shares pursuant to bond conversion	126,633	1	1,006	-	1,007
Net loss and comprehensive loss	-	-	-	(16,797 )	(16,797 )
Balance as of September 30, 2015	17,861,658	\$179	\$321,532	\$ (376,316 )	\$ (54,605 )

See accompanying notes to the consolidated financial statements.

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Notes to the Consolidated Financial Statements

## NOTE 1 – DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Consolidated Financial Statements have been prepared by Cadiz Inc., also referred to as “Cadiz” or “the Company”, without audit and should be read in conjunction with the Consolidated Financial Statements and notes thereto included in the Company’s Form 10-K for the year ended December 31, 2014.

## Basis of Presentation

The foregoing Consolidated Financial Statements include the accounts of the Company and contain all adjustments, consisting only of normal recurring adjustments, which management considers necessary for a fair statement of the Company’s financial position, the results of its operations and its cash flows for the periods presented and have been prepared in accordance with generally accepted accounting principles.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates and such differences may be material to the financial statements. The results of operations for the nine months ended September 30, 2015, are not necessarily indicative of results for the entire fiscal year ending December 31, 2015.

## Liquidity

The Consolidated Financial Statements of the Company have been prepared using accounting principles applicable to a going concern, which assumes realization of assets and settlement of liabilities in the normal course of business. The Company incurred losses of \$16.8 million for the nine months ended September 30, 2015, and \$13.8 million for the nine months ended September 30, 2014. The Company had a working capital deficit of \$32.1 million at September 30, 2015, and used cash in operations of \$9.4 million for the nine months ended September 30, 2015, and \$8.5 million for the nine months ended September 30, 2014.

Cash requirements during the nine months ended September 30, 2015, primarily reflect certain administrative and litigation costs related to the Company’s water project development efforts. Currently, the Company’s sole focus is the development of its land and water assets.

In March 2013, the Company completed arrangements with its senior lenders to refinance its then existing \$66 million zero coupon convertible term loan (“Term Loan”). Under the terms of the new arrangements, the existing lenders held \$30 million of non-convertible secured debt at the time of the transaction, with the balance of the Company’s outstanding debt of approximately \$36 million held in a convertible note instrument. Further, the Company increased the capacity of the convertible note instrument with an additional \$17.5 million to be used for working capital purposes. In July 2013, the majority of the \$30 million of non-convertible secured debt was acquired in a private transaction by MSD Credit Opportunity Fund, L.P. (“MSD Credit”). In October 2013, the Company completed arrangements with MSD Credit to increase the secured debt facility by \$10 million to fund additional working capital (“New Term Loan”).

In July 2013, the Company filed a new shelf registration statement on Form S-3 registering the issuance of up to \$40 million in shares of the Company's common stock, preferred stock, warrants, subscription rights, units and certain debt instruments in one or more public offerings. In November 2014, the Company raised approximately \$14.6 million with the sale of 1,435,713 shares at \$10.1751 per share by way of a takedown from this shelf registration.

The \$14.6 million in additional working capital raised in November 2014, as discussed above, together with the Company's existing cash resources, provides the Company with sufficient funds to meet its expected working capital needs through the end of February 2016.

The Company has a first mortgage debt obligation of \$36.9 million coming due in March 2016. Based upon the Company's current and anticipated usage of cash resources, the Company will also require additional working capital during 2016. The Company is evaluating the amount of cash needed, and the manner in which such cash will be raised. The Company has engaged an investment bank and is currently pursuing a refinancing, extension, or extinguishment of the first mortgage. The Company may meet any future cash requirements through a variety of means, including equity or debt placements, or through the sale or other disposition of assets. Any extinguishment of the first mortgage could occur through a sale or leasing transaction that would make use of a portion of the existing agricultural land and water assets, minimize dilution and be compatible with the implementation of the Water Project.

Limitations on the Company's liquidity and ability to raise capital may adversely affect it. Sufficient liquidity is critical to meet its resource development activities. Although the Company currently expects its sources of capital to be sufficient to meet its liquidity needs through the end of February 2016, if the Company cannot raise needed funds or refinance its current \$36.9 million debt obligation prior to maturity in March 2016, it might default on its debt obligations, and, accordingly, there would be substantial doubt about the Company's ability to continue as a going concern.

#### Supplemental Cash Flow Information

No cash payments, including interest, are due on the corporate secured debt or convertible notes prior to their maturities.

During the nine months ended September 30, 2015, approximately \$1.0 million in convertible notes were converted by certain of the Company's lenders. As a result, 126,633 shares of common stock were issued to the lenders.

The Company recorded \$755 thousand in non-cash additions to fixed assets during the period ended September 30, 2015.

#### Recent Accounting Pronouncements

##### Accounting Guidance Not Yet Adopted

On May 28, 2014, the FASB issued an accounting standards update on revenue recognition including enhanced disclosures. Under the new standard, revenue is recognized when (or as) a good or service is transferred to the customer and the customer obtains control of the good or service. On July 9, 2015, the FASB approved a one-year deferral, updating the effective date to January 1, 2018. The Company is currently evaluating this new guidance and cannot determine the impact of this standard at this time.

In August 2014, the FASB issued an accounting standards update requiring an entity's management to evaluate whether there are conditions or events, considered in aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). The Company is currently evaluating this new guidance which is effective for the first annual period ending after December 15, 2016, and for all annual and interim periods thereafter, and cannot determine the impact of this standard at this time.

On April 7, 2015, the FASB issued an accounting standards update that will require debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability, consistent with debt discounts. Currently, these costs are presented as a deferred charge asset. The Company is currently evaluating this new guidance which is effective for fiscal years beginning after December 15, 2015, and all annual and interim periods thereafter, and expects this new standard will not have a material impact on the consolidated financial statements.

#### NOTE 2 – LONG-TERM DEBT

The carrying value of the Company's debt approximates fair value. The fair value of the Company's debt (Level 2) is determined based on an estimation of discounted future cash flows of the debt at rates currently quoted or offered to the Company by its lenders for similar debt instruments of comparable maturities.

#### NOTE 3 – STOCK-BASED COMPENSATION PLANS AND WARRANTS

The Company has issued options and has granted stock awards pursuant to its 2009 Equity Incentive Plan and 2014 Equity Incentive Plan, as described below.

##### 2009 Equity Incentive Plan

The 2009 Equity Incentive Plan was approved by stockholders at the 2009 Annual Meeting. The plan provides for the grant and issuance of up to 850,000 shares and options to the Company's employees and consultants. The plan became effective when the Company filed a registration statement on Form S-8 on December 18, 2009. All options issued under the 2009 Equity Incentive Plan have a ten-year term with vesting periods ranging from issuance date to 24 months. As of September 30, 2015, 507,500 common stock options remain outstanding under this plan.

## 2014 Equity Incentive Plan

The 2014 Equity Incentive Plan was approved by stockholders at the June 10, 2014 Annual Meeting. The plan provides for the grant and issuance of up to 675,000 shares and options to the Company's employees, directors and consultants. Upon approval of the 2014 Equity Incentive Plan, all shares of common stock that remained available for award under the 2009 Equity Incentive Plan were cancelled. Following registration of the 2014 Plan on Form S-8, the Company entered into revised employment agreements with certain senior management that provide for the issuance of up to 162,500 Restricted Stock Units ("RSU's") during the period July 1, 2014 through December 31, 2016 and the issuance of up to 200,000 RSU's in connection with obtaining construction financing for the Water Project. Of the 162,500 restricted stock units granted on July 1, 2014 pursuant to these employment agreements, 81,250 shares are vested as of September 30, 2015.

Under the 2014 Equity Incentive Plan, each outside director receives \$30,000 of cash compensation and receives a deferred stock award consisting of shares of the Company's common stock with a value equal to \$20,000 on June 30 of each year. The award accrues on a quarterly basis, with \$7,500 of cash compensation and \$5,000 of stock earned for each fiscal quarter in which a director serves. The deferred stock award vests automatically on January 31 in the year following the award date.

All options that have been issued under the above plans have been issued to officers, employees and consultants of the Company. In total, options to purchase 507,500 shares were unexercised and outstanding on September 30, 2015, under the two equity incentive plans.

The Company recognized no stock option related compensation costs in each of the nine months ended September 30, 2015 and 2014. Additionally, no options were exercised during the nine months ended September 30, 2015.

## Stock Awards to Directors, Officers, and Consultants

The Company has granted stock awards pursuant to its 2009 Equity Incentive Plan and 2014 Equity Incentive Plan.

Of the total 850,000 shares reserved under the 2009 Equity Incentive Plan, 115,000 restricted shares of common stock were granted on January 14, 2010, and 140,000 restricted shares of common stock were granted on January 10, 2011. Of the remaining 595,000 shares reserved under the 2009 Equity Incentive Plan, 42,265 shares of common stock were awarded to directors, 507,500 were issued as options as described above as of September 30, 2015. Upon approval of the 2014 Equity Incentive Plan in June 2014, 45,235 shares remaining available for award under the 2009 Equity Incentive Plan were cancelled.

Under the 2014 Equity Incentive Plan, 75,445 shares have been awarded to the Company directors and consultants as of September 30, 2015. Of the 75,445 shares awarded, 11,850 shares have been awarded to the Company's directors for services performed during the plan year ended June 30, 2015. These shares will vest and be issued on January 31, 2016.

The Company recognized stock-based compensation costs of \$721,000 and \$544,000 for the nine months ended September 30, 2015 and 2014, respectively.

#### NOTE 4 – INCOME TAXES

As of September 30, 2015, the Company had net operating loss (“NOL”) carryforwards of approximately \$236 million for federal income tax purposes and \$144 million for California state income tax purposes. Such carryforwards expire in varying amounts through the year 2035. Use of the carryforward amounts is subject to an annual limitation as a result of ownership changes.

As of September 30, 2015, the Company possessed unrecognized tax benefits totaling approximately \$2.8 million. None of these, if recognized, would affect the Company's effective tax rate because the Company has recorded a full valuation allowance against its net deferred tax assets.

The Company's tax years 2011 through 2014 remain subject to examination by the Internal Revenue Service, and tax years 2010 through 2014 remain subject to examination by California tax jurisdictions. In addition, the Company's loss carryforward amounts are generally subject to examination and adjustment for a period of three years for federal tax purposes and four years for California purposes, beginning when such carryovers are utilized to reduce taxes in a future tax year.

Because it is more likely than not that the Company will not realize its net deferred tax assets, it has recorded a full valuation allowance against these assets. Accordingly, no deferred tax asset has been reflected in the accompanying consolidated balance sheets.

#### NOTE 5 – NET LOSS PER COMMON SHARE

Basic net loss per share is computed by dividing the net loss by the weighted-average common shares outstanding. Options, deferred stock units, warrants and the zero coupon term loan convertible into or exercisable for certain shares of the Company's common stock were not considered in the computation of net loss per share because their inclusion would have been antidilutive. Had these instruments been included, the fully diluted weighted average shares outstanding would have increased by approximately 8,543,000 and 8,713,000 for the three months ended September 30, 2015 and 2014, respectively, and 8,414,000 and 8,477,000 for the nine months ended September 30, 2015 and 2014, respectively.

#### NOTE 6 – CONTINGENCIES

On April 24, 2015, a putative class action lawsuit, entitled *Van Wingerden v. Cadiz Inc., et al.*, No. 2:15-cv-03080-JAK-JEM, was filed against Cadiz and certain of its directors and officers (“Defendants”) in the United States District Court for the Central District of California purporting to assert claims for violation of §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The complaint, which purports to be brought on behalf of all Cadiz shareholders, alleges that the Company's public disclosures were inadequate in relation to the Cadiz Valley Water Conservation, Recovery and Storage Project (the “Water Project”). The complaint seeks unspecified monetary damages and other relief.

The Company believes that the claims alleged in the purported class action lawsuit are baseless and without merit and Cadiz intends to vigorously defend against the action.

While the Company believes that the purported class action lawsuit is without merit, pursuant to applicable accounting requirements, the Company will evaluate this matter on an ongoing basis and record accruals for contingencies if the Company concludes that it is probable that a material loss will be incurred and the amount of the loss can be reasonably estimated. In many situations, including the purported class action, in which such matters are being contested, the outcome is not predictable and any potential loss is not estimable.

There are no other material legal proceedings pending to which the Company is a party or of which any of the Company's property is the subject.

#### NOTE 7 – SUBSEQUENT EVENTS

On October 2, 2015, the Company became aware of a letter from the Director of the California Office of the U. S. Bureau of Land Management (“BLM”) that would later be sent to the Company finding that the Water Project pipeline is outside the scope of the Arizona California Railroad right-of-way and would therefore require a new federal right-of-way permit prior to construction.

The Company is currently taking steps further outlined in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations to respond and/or comply with this requirement.

As a result of the BLM communication, on October 5, 2015, the Company's closing stock price fell significantly and continues to trade generally between \$2.92 and \$3.94 per share. If the Company was to assess its goodwill impairment using these lower stock prices, the Company would likely recognize a goodwill impairment charge equal to the carrying value of its goodwill. If the Company's stock price does not increase in the near term, then it is likely that it will be recognizing a goodwill impairment charge in the fourth quarter of this year.

## ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, the following discussion contains trend analysis and other forward-looking statements. Forward-looking statements can be identified by the use of words such as "intends", "anticipates", "believes", "estimates", "projects", "forecasts", "expects", "plans" and "proposes". Although we believe that the expectations reflected in these forward-looking statements are based on reasonable assumptions, there are a number of risks and uncertainties that could cause actual results to differ materially from these forward-looking statements. These include, among others, our ability to maximize value from our Cadiz, California land and water resources; and our ability to obtain new financings as needed to meet our ongoing working capital needs. See additional discussion under the heading "Risk Factors" in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014.

### Executive Summary

Cadiz Inc. ("Cadiz" or the "Company") is a land and water resource development company primarily focused on the development of the Cadiz Valley Water Conservation, Recovery and Storage Project ("Water Project" or "Project"), which will capture and conserve millions of acre-feet of native groundwater currently being lost to evaporation from the aquifer system beneath our 35,000-acre Cadiz Valley property and deliver it to water providers throughout Southern California (see "Water Resource Development") as a new water supply. We believe that the ultimate implementation of this Water Project will create the primary source of our future cash flow and, accordingly, our working capital requirements relate largely to the development activities associated with this Water Project.

The Water Project has already completed a required environmental permitting process under California law and is presently completing final objectives prior to initiating construction of project facilities. The Company received a letter in October 2015 from the Director of the California Office of the U.S. Bureau of Land Management ("BLM") that one of those objectives, the certification of the Water Project's conveyance pipeline route by the BLM, is outside the scope of the Arizona California railroad right-of-way and would therefore require a new federal right-of-way permit prior to construction. The steps the Company now has underway to progress a Project right-of-way are outlined below under Water Resource Development - (1) A Water Conveyance Pipeline Right-of-Way from the Water Project Area to a Delivery System.

Additional final objectives include:

- Resolution of outstanding appeals of the 2014 trial court decisions affirming that the public agencies, Santa Margarita Water District ("SMWD") and the County of San Bernardino ("County") acted properly in approving the Water Project under the California Environmental Quality Act. The appeals were filed by the petitioners in the six original trial court cases with the California Court of Appeals, Fourth District (see Water Resource Development, Item (3) below); and
- Finalization of water transportation arrangements by the Metropolitan Water District of Southern California ("MWD") to deliver Cadiz Project water to end users (see Water Resource Development, Item (3) below).

As a result of the BLM communication, on October 5, 2015, the Company's closing stock price fell significantly and continues to trade generally between \$2.92 and \$3.94 per share. If the Company was to assess its goodwill impairment using these lower stock prices, the Company would likely recognize a goodwill impairment charge equal to the carrying value of its goodwill. If the Company's stock price does not increase in the near term, then it is likely that it will be recognizing a goodwill impairment charge in the fourth quarter of this year

Additionally, the Company has a first mortgage obligation of \$36.9 million due in March of 2016. The Company will need to extinguish, extend or replace this first mortgage obligation prior to that time. The Company holds significant land and water assets securing this mortgage that could also be used for agriculture. Agricultural land in California with water rights has continued to increase in value. The Company is currently pursuing either an extension, a refinancing, or an extinguishment of this first mortgage obligation. Any extinguishment of the first mortgage obligation could occur through a sale or leasing transaction that would make use of a portion of the existing agricultural land and water assets and remain compatible with the implementation of the Water Project.

## Overview

We are a land and water resource development company with 45,000 acres of land in three separate areas of eastern San Bernardino County, California. Virtually all of this land is underlain by high-quality, naturally recharging groundwater resources, and is situated in proximity to the Colorado River and the Colorado River Aqueduct ("CRA"), the major source of imported water for Southern California. Our main objective is to realize the highest and best use of these land and water resources in an environmentally responsible way.

For more than 20 years, we have maintained an agricultural development at our 35,000-acre property in the Cadiz Valley ("Cadiz/Fenner Property"), relying upon groundwater from the underlying aquifer system for irrigation. In 1993, we secured permits to develop agriculture on up to 9,600 acres of the Cadiz Valley property and withdraw more than one million acre-feet of groundwater from the underlying aquifer system. Since that time, we have maintained various levels of agriculture at the property and this operation has provided our principal source of revenue.

While we believe that the long-term highest and best use of our land and water assets can best be derived through the development of a combination of water supply and storage projects at our properties, there is increased demand for agricultural land with water rights. Therefore, while the Company is primarily focused on the development of the Water Project, which will capture and conserve millions of acre-feet<sup>1</sup> of native groundwater currently being lost to evaporation from the aquifer system beneath our Cadiz/Fenner Property and deliver it to water providers throughout Southern California (see "Water Resource Development"), we are also exploring ways in which the water currently being lost can be put to beneficial use through sale, lease, or agricultural joint ventures that are complimentary with the Water Project. Through work completed during the third quarter, including the drilling of three additional exploratory wells, we have now identified suitable locations for high production wells powered by natural gas that could produce all of the water allowable under our existing permit for implementation of the Water Project or alternatively to supply water for all of the agricultural land under our conditional use permit. The full build out of this additional well-field is estimated to cost approximately \$35 million. While we believe that the ultimate implementation of the Water Project will provide the primary source of our future cash flow, we also believe there is currently significant additional value in our underlying agricultural assets. Accordingly, our working capital requirements relate largely to the final development activities associated with this Water Project and those activities consistent with the Water Project related to further development of our underlying agricultural assets.

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<sup>1</sup> One acre-foot is equal to approximately 326,000 gallons or the volume of water that will cover an area of one acre to a depth of one-foot. An acre-foot is generally considered to be enough water to meet the annual water needs of one average California household.



The primary factor driving the value of such projects is continuing pressure on water supplies throughout California, which has led Southern California water providers to actively seek new, reliable supply solutions to plan for both short and long-term water needs. Available supply is constrained by environmental and regulatory restrictions on each of the State's three main water sources: the State Water Project, which provides water supplies from Northern California to the central and southern parts of the state, the CRA and the Los Angeles Aqueduct. Southern California's water providers rely on imports from these systems for a majority of their water supplies, but deliveries from all three into the region have been below capacity over the last several years.

Availability of supplies in California also differs greatly from year to year due to natural hydrological variability. California is presently mired in its fourth year of drought, with more than 90% of the State in a severe drought condition, according to the United States Drought Monitor. In April 2015, California Governor Jerry Brown issued an Executive Order imposing the State's first-ever mandatory 25% reduction in urban water use effective for 12 months. Also in April 2015, the Metropolitan Water District of Southern California adopted mandatory rationing, which limits the availability of imported supplies for water providers throughout the region. The Water Project is one of the few available new supply options in Southern California that could help alleviate the region's water supply challenges.

In addition to our water resource development activities, we also continue to explore additional uses of our land and water resource assets, including new agricultural opportunities, the development of a land conservation bank on our properties outside the Water Project area and other long-term legacy uses of our properties, such as habitat conservation and cultural uses.

We will also pursue strategic investments in complementary business or infrastructure to meet our objectives. We cannot predict with certainty when or if these objectives will be realized.

#### Water Resource Development

The Water Project is designed to capture and conserve billions of gallons of renewable native groundwater currently being lost annually to evaporation from the aquifer system underlying our Cadiz/Fenner Property, and provide a reliable water supply to water users in Southern California. By implementing established groundwater management practices, the Water Project will create a new, sustainable water supply for project participants without adversely impacting the aquifer system or the desert environment. The total quantity of groundwater to be recovered and conveyed to Water Project participants will not exceed a long-term annual average of 50,000 acre-feet per year for 50 years. The Water Project also offers participants the ability to carry-over their annual supply, and store it in the groundwater basin from year to year. A second phase of the Water Project, Phase II, will offer approximately one million acre-feet of underground storage capacity that can be used to hold imported water supplies at the Water Project area.

Water Project facilities required for Phase I primarily include, among other things:

- High yield wells designed to efficiently recover available native groundwater from beneath the Water Project area;
- A water conveyance pipeline to deliver water from the well field to Project participants; and
- An energy source to provide power to the well-field, pipeline and pumping plant.

If an imported water storage component of the Water Project is ultimately implemented in Phase II, the following additional facilities would be required, among other things:

- A pumping plant to pump water through the conveyance pipeline from the CRA to the Water Project well-field; and
- Spreading basins, which are shallow settling ponds that will be configured to efficiently percolate water from the ground surface down to the water table using subsurface storage capacity for the storage of water.

In general, several elements are needed to implement such a project: (1) a water conveyance pipeline right-of-way from the Water Project area to a delivery system; (2) storage and supply agreements with one or more public water agencies or private water utilities; (3) environmental/regulatory permits; and (4) construction and working capital. As described below, the first three elements have been progressed on a concurrent basis. The fourth is dependent on actions arising from the completion of the first three.

#### (1) A Water Conveyance Pipeline Right-of-Way from the Water Project Area to a Delivery System

In September 2008, we secured a right-of-way for the Water Project's water conveyance pipeline by entering into a lease agreement with the Arizona & California Railroad Company ("ARZC"), which operates an active shortline railroad extending from Cadiz to Matthie, Arizona. The agreement allows for the use of a portion of the railroad's right-of-way to construct and operate a water conveyance pipeline for a period of up to 99 years. The buried pipeline would be constructed parallel to the railroad tracks and be used to convey water between our Cadiz/Fenner Property and the CRA in Freda, California.

Our lease agreement with the ARZC also expressly requires that the Project further several railroad purposes and, under the terms of the lease agreement, the ARZC reserved water supplies from the Project for its operational needs as well as access to Project facilities, such as roads and power appurtenances, for the benefit of its railroad operation. In September 2013, we also entered into a trackage rights agreement with the ARZC that would enable the operation of steam-powered, passenger excursion trains on the line powered by water made available from the pipeline.

The pipeline route was fully analyzed in the Water Project's Final Environmental Impact Report ("EIR") as part of the CEQA environmental review process completed in 2012 and was found to be the environmentally preferred route for the pipeline. As an existing transportation corridor, the route avoids sensitive habitats. Our plan to construct the Project pipeline within the railroad right-of-way is similar to, and modeled after, the thousands of other existing longitudinal uses of rail corridors across the United States today, such as telecommunications lines, natural gas and petroleum product lines and other water lines. Under the General Railroad Right-of-Way Act of March 3, 1875 ("1875 Act"), according to which many of these railroad corridors were established, a railroad can lease its property for third party uses without permitting of the federal government so long as the use also derives from or furthers railroad purposes, at least in part. This interpretation of the 1875 Act was confirmed by Memorandum Opinion M-37025 issued by the Solicitor of the US Department of the Interior on November 4, 2011 ("2011 M-Opinion").

The Project includes the following features provided in furtherance of railroad purposes:

- A new access road along the entire pipeline route to enable maintenance, emergency access and shorten routes for crew-changes,
  - Remotely operated fire-suppression systems at each of the existing creosote-treated wooden trestles,
- Inline power generation for crossing operations and lighting, heating and cooling for existing railroad transloading operations,
- Fiber optic information transmission to convey track-speed and cameras in aid of emergency and to discourage vandalism; and
- The distribution of water for the operation of a steam powered locomotive, fire-suppression and other miscellaneous uses.

In August 2014, the U.S. Bureau of Land Management issued guidance (Instruction Memorandum No. 2014-122) to its field offices requiring the evaluation of all existing and proposed uses of 1875 Act railroad rights-of-way to ensure consistency with the M-Opinion. While there are thousands of existing uses of 1875 Act railroad right-of-ways across the US, the Water Project conveyance pipeline was chosen to be the first evaluated by the BLM under the 2011 M-Opinion and Instruction Memorandum No. 2014-122. After numerous meetings, discussion and our submission of support documentation, the Company received notification from the BLM California Office in April 2015 that it was analyzing the Project's proposed use of the ARZC right-of-way and expected to provide the results of this evaluation to the BLM Washington D.C. office by the end of summer 2015.

Without any further consultation, on October 2, 2015, the Director of the California Office of the BLM signed a letter that would later be sent to ARZC and the Company summarizing that the Project pipeline is outside the scope of the ARZC right-of-way and would therefore require a new federal right-of-way permit prior to construction. This guidance appears to disregard the framework established by the 2011 M-Opinion and the IM No. 2014-122, as its underlying premise is that while the Project's proposed use may further railroad purposes, these purposes derive from a pipeline which is not an original railroad purpose. We believe this finding strays from framework provided for in the binding 2011 M-Opinion, which states in relevant part:

“Within an 1875 Act ROW, a railroad’s authority to undertake or authorize activities is limited to those activities that derive from or further a railroad purpose, which allows a railroad to undertake, or others to undertake, activities that have both railroad and commercial purposes, but does not permit a railroad to authorize activities that bear no relationship to the construction and operation of a railroad.” (Emphasis added, M-37025)

The Director of the California Office of the BLM noted that this guidance was not a final agency action and is subject to reconsideration upon the presentation of new information and in the public interest. Therefore, the Company and its partners are presently pursuing a reconsideration of the BLM guidance.

Initially the Company is pursuing legislative and administrative means to seek a reconsideration of this guidance. If legislative and administrative remedies are unable to overturn the guidance, then we expect to pursue one or more of the following options to provide an access point for conserved water supplies to the Project participants:

1. Apply for a new federal right-of-way permit for the conveyance of water for public consumption on: (i) the 43-mile ARZC route, (ii) the 35-mile route approved by BLM in 2002 for an earlier iteration of the Water Project<sup>2</sup> and/or (iii) the existing northern 96-mile route (see 4. Construction and Working Capital, Existing Pipeline Asset below). The 2002 route and the 96 mile-route were both analyzed as alternative in the Water Project’s final EIR.

Any right-of-way application for these routes would be limited to the conveyance of conserved water for public consumption (Phase 1 project description) and would not include groundwater storage (Phase 2 project description), because BLM review of an application for a groundwater storage project is currently precluded by a policy rider on BLM’s federal appropriations bill.

2. The Company is also considering clarifying the ARZC’s rights to its right-of-way in federal court. Federal courts have exclusive jurisdiction to determine questions of title, including the scope of railroad right-of-ways, so we believe a federal court could properly declare title in this instance and bind BLM regardless of its administrative guidance memorandum. We believe that there may also be other judicial remedies to resolve whether the pipeline may be placed within a railroad right-of-way and are considering such remedies as well.

While these approaches will likely result in a delay for the construction of the Project pipeline, we believe they will ultimately result in one or more permitted routes for the Project.

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<sup>2</sup> As previously disclosed in the Company’s SEC filings, in 2002, the US BLM/US Department of the Interior approved an earlier iteration of the Water Project, then referred to as the Cadiz Valley Groundwater Storage & Dry Year Supply Program, and offered the Metropolitan Water District of Southern California, the Program’s lead agency at the time, a right-of-way for a water conveyance pipeline over 35-miles of open federal land. See 8-29-2002 Record of Decision for the Cadiz Project, BLM Case File No. CA-4046.

## (2) Storage and Supply Agreements with One or More Public Water Agencies or Private Water Utilities

In 2010 and 2011, we entered into option and environmental cost sharing agreements with six water providers: Santa Margarita Water District (“SMWD”), Golden State Water Company (a wholly owned subsidiary of American States Water [NYSE: AWR]), Three Valleys Municipal Water District, Suburban Water Systems (a wholly owned subsidiary of SouthWest Water Company), Jurupa Community Services District and California Water Service Company, the third largest investor-owned American water utility. The six water providers serve more than one million customers in cities throughout California’s San Bernardino, Riverside, Los Angeles, Orange, Imperial and Ventura Counties.

Following CEQA certification, SMWD was the first participant to convert its option agreement and adopt resolutions approving a Water Purchase and Sale Agreement for 5,000 acre-feet of water. The structure of the SMWD purchase agreement calls for an annually adjusted water supply payment, plus a pro rata portion of the capital recovery charge and operating and maintenance costs. The capital recovery charge is calculated by amortizing the total capital investment by the Company over a 30-year term. Under the terms of the option agreements with the other five water providers named above, each agency has the right to acquire an annual supply of 5,000 acre-feet of water at \$775 per acre-foot (2010 dollars), which is competitive with their incremental cost of new water. In addition, these agencies have options to acquire storage rights in the Water Project to allow for the management of their Water Project supplies in complement with their other water resources. Up to 150,000 acre-feet of carry-over storage is available for reservation by the agencies prior to construction commencement. Participants that elect to achieve year-to-year flexibility in their use of Project water by utilizing carry-over storage will reserve storage capacity for \$1,500 per AF prior to construction. We are currently working with our water provider participants to convert their option agreements to definitive economic agreements.

In 2014, we also executed Letters of Intent (“LOIs”) with two California water providers and two California agricultural entities reserving up to 20,000 acre-feet of water per year from the Water Project at \$960/acre-foot (2014 dollars) delivered to the Colorado River Aqueduct. The delivery of Project water to agricultural entities will be subject to an exchange with an eligible State Water Project contractor. The terms of any exchange would be finalized prior to commencement of Project construction.

We have executed LOIs, option agreements and purchase agreements that are in excess of Water Project capacity and are working collaboratively with the participating water providers to account for any oversubscription in the final definitive Purchase and Sale Agreements (“PSAs”). Final definitive PSAs would be entered into prior to completing construction finance arrangements.

## (3) Environmental/Regulatory Permits

In order to properly develop and quantify the sustainability of the Water Project, and prior to initiating the formal permitting process for the Water Project, we commissioned environmental consulting firm CH2M HILL to complete a comprehensive study of the water resources at the Project area. Following a year of analysis, CH2M HILL released its study of the aquifer system in February 2010. Utilizing new models produced by the U.S. Geological Survey in 2006 and 2008, the study estimated the total groundwater in storage in the aquifer system to be between 17 and 34 million acre-feet, a quantity on par with Lake Mead, the nation’s largest surface reservoir. The study also identified a renewable annual supply of native groundwater in the aquifer system currently being lost to evaporation. CH2M HILL’s findings, which were peer reviewed by leading groundwater experts, confirmed that the aquifer system could sustainably support the Water Project.

Further, and also prior to beginning the formal environmental permitting process, we entered into a Memorandum of Understanding (“MOU”) with the Natural Heritage Institute (“NHI”), a leading global environmental organization committed to protecting aquatic ecosystems, to assist with our efforts to sustainably manage the development of our Cadiz/Fenner Property. As part of this “Green Compact”, we will follow stringent plans for groundwater management and habitat conservation.

#### CEQA review

As discussed in (2), above, we entered into environmental cost-sharing agreements with all participating water providers creating a framework for funds to be committed by each participant to share in the costs associated with the CEQA review work. SMWD served as the lead agency for the review process, which began in February 2011 with SMWD’s issuance of a Notice of Preparation (“NOP”) of a Draft Environmental Impact Report (“Draft EIR”).

Following two NOP public scoping meetings, SMWD released the Draft EIR in December 2011. The Draft EIR analyzed potential impacts to environmental resources at the Water Project area, including critical resources of the desert environment such as vegetation, mountain springs, and water and air quality. The analysis of the Water Project considered peer-reviewed technical reports, independently collected data, existing reports and the Project’s state of the art Groundwater Management, Monitoring and Mitigation Plan (“GMMMP”). SMWD held a 100-day public comment period for the Draft EIR, during which SMWD hosted two public comment meetings and an informational workshop.

In May 2012, SMWD, Cadiz and the County of San Bernardino also entered into a Memorandum of Understanding creating the framework for finalizing the GMMMP in accordance with the County’s desert groundwater ordinance.

In July 2012, SMWD released the Final EIR and responses to public comments. The Final EIR summarized that, with the exception of unavoidable short-term construction emissions, by implementing the measures developed in the GMMMP, the Project will avoid significant impacts to desert resources. A public hearing was held on July 25, 2012 by the SMWD Board of Directors to take public testimony and consider certification of the Final EIR. On July 31, 2012, the SMWD Board of Directors certified the Final EIR and approved the Project.

Following SMWD’s certification of the Final EIR, the San Bernardino County Board of Supervisors voted on October 1, 2012 to approve the GMMMP for the Project and adopted certain findings under CEQA, becoming the first Responsible Agency to take an approving action pursuant to the certified EIR. San Bernardino County served as a Responsible Agency in the CEQA review process as the local government entity responsible for oversight over groundwater resources in the Cadiz Valley.

## CEQA Litigation

Third parties in California have the ability to challenge CEQA approvals in State Court and, in 2012, the Company was named as a real-party-in-interest in nine lawsuits challenging the various Water Project approvals granted by SMWD and San Bernardino County. In 2013, three cases were dismissed or otherwise settled. Trial in the six remaining cases, which were brought by two petitioners, began in December 2013 and concluded in February 2014. In September 2014, the Court issued final signed judgments (“Judgments”) formally denying all claims brought in the six lawsuits. The Judgments upheld the environmental review and approvals of the Water Project and also awarded costs to SMWD, the County, Cadiz and Fenner Valley Mutual Water Company as the prevailing parties in the cases.

During the fourth quarter of 2014, the petitioners filed independent appeals of the six Judgments in the California Court of Appeals, Fourth District. These appeals were anticipated and are expected to be heard and potentially ruled upon by the Appeals Court in the fourth quarter of 2015. The appeals process does not impact the Company’s ongoing implementation and pre-construction activities for the Water Project.

## Metropolitan Water District of Southern California Conveyance Terms

In addition, prior to construction of the Project, the Metropolitan Water District of Southern California (“MWD”), which owns and controls the CRA, must take action as a responsible agency under CEQA regarding the terms and conditions of the Water Project’s use of the CRA to transport water to its participating agencies. Water Project supplies will enter Metropolitan’s CRA in accordance with its published engineering, design and water quality standards and subject to all applicable fees and charges routinely established by Metropolitan for the conveyance of water within its service territory.

The Project’s participating agencies led by Santa Margarita Water District (SMWD) and the Municipal Water District of Orange County (MWDOC) - SMWD’s representative on the MWD Board of Directors – are presently engaged in dialogue with MWD and have been exchanging engineering information since November of 2014 pertinent to MWD’s conveyance of Project supplies. We are supporting this ongoing data exchange, but are not the lead party to these discussions since an agreement outlining the terms and conditions of conveyance of Project water would be entered into between MWD and the Project’s participating agencies, not the Company. These agencies, described in (2) above, are primarily retail agencies within the MWD service area and are acquiring needed supplemental water supplies from the Water Project. Any final conveyance agreement will be considered by the MWD Board when it is completed by MWD staff and the participating agencies request it be considered.

As a condition of conveyance, Metropolitan has expressed to the participating agencies that certain water quality standards must be met prior to entering the CRA. Cadiz water is very low in total dissolved solids (“TDS”) and has historically met every state and federal maximum contaminant level (“MCL”) for water quality. However, in 2014, the State of California adopted the first-ever standard for Chromium 6, a heavy metal that can naturally occur in groundwater when manganese oxides, at 10 parts per billion (“ppb”). We have determined that some of our wells contain naturally occurring Chromium 6 in levels that slightly exceed the state MCL and therefore expect our water would need to be treated prior to entering the CRA. We have participated in research and development of Chromium 6 treatment technologies and believe that we can meet this standard in a cost-effective manner. Potential costs, which would be borne by Cadiz and not the participating agencies, have already been factored into our estimates for capital expenditures and operations and maintenance.

(4) Construction and Working Capital

As part of the Water Purchase and Sale Agreement with SMWD referred to in (2), above, SMWD is further authorized to continue next steps with the Company, which includes final permitting, design and construction.

As described above, construction of Phase I of the Water Project would primarily consist of wellfield facilities at the Project site, a conveyance pipeline extending approximately 43 miles along the right-of-way described in (1), above, from the wellfield to the CRA, and an energy source to pump water through the conveyance pipeline between the Project well-field and the CRA. The construction of these facilities, which we expect would cost between \$225 – \$250 million, will require capital financing that we expect to be secured by the proceeds of our definitive Purchase and Sale Agreements described above and the new facility assets. Of this amount, approximately \$35 million would be necessary for construction of the well-field. The Company’s existing corporate term debt provides us the flexibility to incorporate Water Project construction financing up to \$300 million within our current debt structure.

Existing wells at the Cadiz/Fenner Property currently in use for our agricultural operations will be integrated into the Water Project well-field, reducing the number of wells that must be constructed prior to Project implementation. To the extent additional agricultural wells are placed in service, they would also be integrated into the Water Project well-field.

Existing Pipeline Asset

As described above (see “Water Resource Development”), we currently hold ownership rights to a 96-mile existing idle natural gas pipeline from the Cadiz/Fenner Property to Barstow, California that would be converted for the transportation of water.

In September 2011, we entered into an agreement with El Paso Natural Gas (“EPNG”), a subsidiary of Kinder Morgan Inc., providing us with rights to purchase approximately 220-miles of idle, natural gas pipeline between Bakersfield and Cadiz, California for \$40 million.

Initial feasibility studies indicated that upon conversion, the 30-inch line could transport between 20,000 and 30,000 acre-feet of water per year between the Water Project area and various points along the Central and Northern California water transportation network. In February 2012, we made a \$1 million payment to EPNG to extend our option to purchase the 220-mile line until April 2013.

In December 2012, we entered into a new agreement with EPNG dividing the 220-mile pipeline in Barstow, California, with the Company gaining ownership rights to the 96-mile eastern segment between Barstow and the Cadiz Valley and returning to EPNG rights to the 124-mile western segment for its own use. The 96-mile eastern portion from the Cadiz Valley to Barstow was identified as the most critical segment of the line for accessing the state’s water transportation infrastructure. The Barstow area serves as a hub for water delivered from northern and central California to communities in Southern California’s High Desert.